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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943.

No. 195.

NORTHWESTERN ELECTRIC COMPANY and AMERICAN POWER & LIGHT COMPANY,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

REPLY BRIEF FOR THE PETITIONERS.

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TABLE OF CONTENTS.

SUBJECT INDEX.

	PAGE
INTRODUCTORY STATEMENT	1
I. COMMISSION'S BRIEF MISINTERPRETS ISSUES AND MISCONSTRUES CONTENTIONS OF PETITIONERS	2
Petitioners' "Failure" to Submit a "Plan of Disposition"	2
The "Write-up"	4
Recording of "Fluctuations of Value" Not Contemplated	4
Petitioners Question Commission Power in Circumstances of this Case	5
II. COMMISSION'S AUTHORITY TO REQUIRE "DISPOSITION" IN CIRCUMSTANCES OF THIS CASE, NOT "*Res Adjudicata*"	6
Lower Court's Own Language Best Expression of What it Meant	6
Commission Counsel's Past and Current Contentions	8
III. "DISPOSITION", AS DISTINGUISHED FROM FULL DISCLOSURE BY CLASSIFICATION, NEITHER "NECESSARY" NOR "APPROPRIATE" TO PERFORMANCE OF COMMISSION'S FUNCTIONS	12
"Accounting Principles" Do Not Require Write-off	12
Disposition Neither "Necessary" Nor "Appropriate"	14

PAGE

The So-Called Licensee Cases 15

Provision Must be Made for "Appreciation" 17

"Corporate Veil" Diaphanous in Both Directions 17

System of Accounts May Not Destroy Property Rights 18

Northwestern's 1936 Reorganization Ignored 19

Original Cost Accounting and the Value Concept 21

This Commission's Own Regulations Are Not Sacrosanct 21

Commission's Order Clearly Is, in Intent and Effect, a Dividend Order and Not An Accounting Order 22

Is Northwestern's Capital Impaired? 24

Federal Power Commission and Securities and Exchange Commission Cover Same Field 26

"Co-ordination" Between Commissions Clearly An Afterthought 27

IV. THE COMMISSION'S BRIEF FAILS TO ANSWER PETITIONERS' ARGUMENTS THAT THE COMMISSION'S ORDER VIOLATES ARTICLES V AND X OF THE AMENDMENTS TO THE CONSTITUTION 28

Congress Has Not Made Federal Regulation Complete 28

Order Takes Property Without Due Process 28

APPENDIX A 32

Table of Cases Cited.

	PAGE
American Telephone & Telegraph Co. v. *United States*, 299 U. S. 232	11, 18, 29
Chicago Junction case, 264 U. S. 258	30
Davis v. *Wakelee*, 156 U. S. 680	12
Edwards v. *Douglas*, 269 U. S. 204	24
Fed. Power Comm'n v. *Edison Co.*, 304 U. S. 375	7
Guaranty Trust Co. of N. Y. v. *United States*, 304 U. S. 126	12
Kansas City Southern Railway case, 231 U. S. 423	29
Michels v. *Olmsted*, 157 U. S. 198	12
Pennsylvania Power & Light Company v. *Federal Power Commission*, ... F. (2d) ....., C. C. A. 3, decided December 7, 1943	17
Randall v. *Bailey*, 288 N. Y. 280	24
United States v. *Chicago, Milwaukee R. Co.*, 282 U. S. 311	12

Statutes Cited.

Federal Power Act:	
Section 3(13)	16
4(b)	16
10(c)	16
10(d)	16
204(f)	25, 28
301(a)	15, 22
305(a)	24, 25, 26
313(b)	10
314	25
318	26

PAGE

Uniform System of Accounts:
Acct. 100.4, Plant Adjustment Account 30
Acct. 100.5, Electric Plant Acquisition Adjustments 17
Acct. 107, Electric Plant Adjustments, 6, 8, 9, 10, 11, 22, 24
Acct. 303, Miscellaneous Intangible Plant 18
Acct. 400, Credit Balance Transferred from Income Account 24
Acct. 414, Miscellaneous Debits to Surplus 24

Federal Constitution:
Fifth Amendment 1, 10
Tenth Amendment 1, 10

Federal Trade Commission 4, 21

Interstate Commerce Commission 16

Public Utility Holding Company Act:
Section 11 29
Section 12(c) 26
Rule U-46(a) 26

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FEDERAL POWER COMMISSION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

REPLY BRIEF FOR THE PETITIONERS.

INTRODUCTORY STATEMENT.

The Commission's brief (a) misinterprets the issues and misconstrues both the facts of the case and the contentions of petitioners, (b) attributes to the court below, and to the Commission itself, conclusions sharply at variance with the language actually used by both court and Commission, (c) mistakes or ignores the significance of the value concept, as that concept is presented in petitioners' brief, and ascribes to certain provisions of the Commission's system of accounts a sanctity which they obviously do not possess, and (d) fails to make any valid answer to petitioners' contentions that the Commission's order violates Amendments V and X to the Constitution.

It is impracticable, within the compass of a short reply brief, even to point out all of the misconstructions and distortions contained in the Commission's brief, but at least some of them require both designation and discussion.

I. COMMISSION'S BRIEF MISINTERPRETS ISSUES AND MISCONSTRUES CONTENTIONS OF PETITIONERS.

Petitioners' "Failure" to Submit a "Plan of Disposition".

At page 5, the Commission's brief states that the staff report was served upon Northwestern with the "request" that it "submit a plan for disposing of" the amount of $3,500,000 under consideration. It is true that such a request was received, in the form of a letter signed by a member of the Commission staff and containing the express reservation that "nothing contained herein * * * shall prejudice the authority of this Commission * * * with respect to rates, estimates, or determinations of cost, evaluations, services, accounts, or any other matter whatsoever which may come before this Commission * * *" (R. 142). However, the order which called the original hearing before the Commission only directed Northwestern to show cause why the Commission "should not find and determine by order that adjusting entries be made to bring the books of account in conformity with" a report prepared by the Commission's staff (R. 3).

Of course in making its preparation for the original hearing, Northwestern had to decide which of these two "requests" governed, the informal letter signed by a member of the Commission staff or the subsequent, formal order of the Commission. Naturally enough, it assumed that the order was controlling and made its preparations accordingly, wholly without reference to the issue of disposition.

This matter is referred to only because it is so strikingly symptomatic of Commission counsel's approach to many of the questions here presented. Because a Commission staff member requested Northwestern to submit a plan of disposition, it should have responded with alacrity, apparently upon the assumption that, a staff member having spoken, the issues were fully prejudged. Perhaps that was the case, but Northwestern did not feel that its convictions should be abandoned so early in the proceeding.

Similarly, at pages 13, 53 and 57 of the Commission's brief, it is observed that petitioners "failed and refused to submit any plan for the elimination" of the $3,500,000; that Northwestern "had been given an opportunity at the original hearing to propose a method" of disposition and that there had been "an obstinate refusal" on the part of petitioners "to crystalize their objections in the form of helpful suggestions." It surely should not be necessary to reply that, before the Commission's trial examiner, before the Commission itself, before the court below and now in this Court, petitioners have earnestly and consistently urged, and now urge, that, in the light of

> (a) American's investment of more than $5,000,000 in Northwestern's common stock and
>
> (b) values which fully supported the $3,500,000 par value of said common stock (i) when American acquired said stock in 1925, (ii) when Northwestern effected its reorganization in 1936, writing down said common stock from $10,000,000 to $3,500,000 and (iii) when the second hearing in this matter was held

the Commission could not require that said $3,500,000 be arbitrarily written off. Petitioners submit that, having the courage of their value concepts, they were under neither legal nor moral obligation to suggest to their judge-jury-

prosecutor appropriate means of taking their property without due process of law.

The "Write-up".

Many pages of the Commission's brief are devoted to a demonstration that this proceeding involves a "write up." Since the petitioners had already agreed (Pet. Br., p. 15), for the purpose of argument, that when the common stock of Northwestern was originally issued thirty years ago, no electric plant was received in exchange for it, the necessity for such extensive discussion is not apparent. As the Federal Trade Commission (quoted in a footnote at page 29 of the Commission's brief) said, Northwestern's common stock was "actually issued without tangible consideration." The Commission clearly erred in finding that Northwestern's organizers rendered no services to the Company in consideration for the stock they received, but such services could not then have been valued, however imaginatively, at $10,000,000 or $3,500,000 or even $1,000,000. But what the organizers may have done, or may have omitted to do, is glowingly irrelevant, in the light of this record, from the point of view of the present security holders of Northwestern, including American.

Recording of "Fluctuations of Value" Not Contemplated.

There are frequent references in the Commission's brief to the impropriety of recording "fluctuations of value", but of course nothing of the sort is or has been contemplated by Northwestern. There has been a *single* revaluation of the Company's assets giving honest recognition to current values and, of course, under the new systems of accounts, there could be no further "fluctuation"

either upward or downward without the approval of this Commission and of the regulatory authorities of Oregon and Washington. Much is attempted to be made (Comm. Br., 70-72) of the fact that the Oregon and Washington authorities, when they approved the issuance of the new $35 par value common stock in exchange for the old $100 par value common stock made no findings as to value. No such findings either were requested or could be made in the absence of detailed hearings on the subject of value which were then considered unnecessary, but this reservation of jurisdiction by the State authorities by no means negatives the possibility that values equal to or greater than the $3,500,000 in question will be found when the occasion arises.[1]

Petitioners Question Commission Power In Circumstances of this Case.

There may well have been, and may well be in the future, circumstances in which the writing down of plant appreciation not supported by value has been, and will be, fully justified. What the petitioners are questioning is not the power of the Commission to deal with such write-ups, but rather its power to require disposition in the circumstances of this particular case, where a substantial arm's-length investment has been made, where values are real and actual when measured by any normal yardstick and where the "disposition" undertaken by the Commission destroys vested rights (Pet. Br., 40-50). And the Commission's self-

[1] In a footnote at page 5 of the Commission's brief, it is stated that copies of the briefs filed *amici curiae* in the lower court on behalf of the State authorities have been filed with the Clerk of this Court. Our reply to such *amici* briefs in the lower court is being similarly filed.

conferred authority to "dispose"[2] of amounts recorded in Account 107 does not, even *per se*, bestow any power to destroy properly recorded and fully supported values.

American was permitted to intervene, it seems (Comm. Br., 64, footnote 48), as "a matter of grace" and not because the character of the evidence which it proposed to submit was "relevant" or because it was legally "aggrieved". But the fact remains that American had an investment to protect and that it was permitted to seek to do so in this proceeding. Furthermore, the fact that American paid $5,021,799.33 in cash for Northwestern's common stock was admitted as relevant and competent testimony (R. 926-927) and it is difficult to understand how or why the Commission itself could find that inconvenient fact "entirely irrelevant and immaterial" (R. 1167). Perhaps it is irrelevant to a commission which is at once judge, jury and prosecutor and which is intent upon its own concepts, but it is peculiarly and poignantly relevant to the 30,000 stockholders of American.

II. COMMISSION'S AUTHORITY TO REQUIRE "DISPOSITION", IN CIRCUMSTANCES OF THIS CASE, NOT *"RES ADJUDICATA"*.

Lower Court's Own Language Best Expression of What it Meant.

The Commission takes the position (Comm. Br., 18-21) that the issue of whether the Commission may direct disposition of the $3,500,000 classified in Account 107 was decided by the Circuit Court of Appeals on the first review from which no appeal was taken, and that the issue here is

[2] Dispose .1. To distribute and put in place; to arrange; to set in order; as, to *dispose* the ships in the form of a crescent. 2. To assign to a certain place or condition; appoint. 3. To regulate; adjust; settle; determine (*Webster's New International Dictionary*).

limited to the propriety of the method of write-off which the Commission ordered.

In its discussion of the opinion of the lower court, particularly the lower court's opinion on the first review, the Commission's brief sedulously refrains from quoting the Court's language and dilates upon what, in the opinion of Commission counsel, the lower court "necessarily decided" or "clearly disclosed that it had decided." The rationalization involved is interesting, but we nevertheless find it necessary to refer to what the lower court said, believing that its intention perhaps finds best expression in its own language. In this connection, we respectfully direct attention to pages 75 to 78 of our original brief, where actual excerpts from the two opinions of the lower court are set forth. It is true that, on the first review, counsel for Northwestern urged the court to consider the disposition issue and presented a "value" argument, but there is not so much as a single phrase in the court's first opinion to indicate that either the disposition question or our fair value argument on the question of disposition were given any consideration whatever.

Vigorously to the contrary, both in brief and in oral argument, Commission counsel contended that the question of disposition was not before the court on the first review. And they were successful in their endeavor to avoid judicial consideration of the disposition question. In its opinion (R. 819), the lower court said: "With respect to the common-stock item a rehearing of the Commission's order was granted but not decided. Until decided there is no order to review here. *Federal Power Comm'n* v. *Edison Co.*,[3] 304 U. S. 375, 383." Thus, *by the lower court's own*

[3] This was the case chiefly relied upon by the Commission in this connection; see p. 9, *infra*.

decision, upon the first review, it was established as the law of the case that no phase of the question of disposition was then before that court.

Commission Counsel's Past and Current Contentions.

The position now taken by Commission counsel is in direct conflict with their contentions, both in their brief and on oral argument, which led the lower court to hold that the question of disposition was not then (upon the first review) before that court. In order that there may be no misunderstanding as to the disparities between the current contentions of Commission counsel and their contentions before the lower court on the first review, we set forth below excerpts (i) from the Commission's brief before this Court and (ii) from its brief before the lower court upon the first review.

Brief before this Court (pp. 20-23)

"The text of Account 107 itself makes plain that amounts recorded therein cannot remain there permanently, but must be disposed of as the Commission may approve or direct (3 R. Ex. 6, p. 19); hence the court below necessarily decided on the first review that the Commission had power to direct disposition of the 'write-up' from Account 107. There being no account on the asset side of the balance sheet into which this item could be moved, the power of disposition must relate to transfer into the surplus account on the liability side.

Brief before lower court

"On January 9, 1941, Petitioner filed an application for rehearing on the Commission's order of December 6, 1940 (R. 79). On January 21, 1941, the Commission ordered that a rehearing be held on February 10, 1941, 'for the purpose only of permitting the presentation of a plan of disposition of the amount of $3,500,000 write-up which the Commission, in paragraph (2a) of its order of December 6, 1940, ordered Northwestern to make disposition of, * * *' R. 113). On December 30, 1940, the Commission stayed that portion of its order which required the disposi-

Brief before this Court

"This analysis of the scope of the decision on the first review is confirmed by the opinion of the court below, on its review of the Commission's second order (issued on April 14, 1942), which had again directed amortization of the 'write-up' by annual charges to earned surplus (5 R. 1164-1173). On the second review, the court once more rejected the company's 'fair value' argument, which this time was asserted as a bar to the disposition ordered by the Commission. The court thus clearly disclosed that on the first review it had decided the question of the authority to order disposition.

"All matters before the court below on the first review *which either were decided or could have been decided are res judicata.* Consequently petitioners, contrary to their present contentions (Pet. Br. 75-80), are foreclosed from reopening, in this review, the validity of the system of accounts prescribed, the classification of the $3,500,000 item as a 'write-up' in Account 107, or the authority of the Commission to order appropriate disposition of that amount. *Chicot County Dist.* v. *Bank*, 308 U. S. 371, 378; *American Surety Co.* v. *Baldwin*, 287 U. S. 156, 166-167; *Grubb* v. *Public Utilities Comm.*, 281 U. S.

Brief before lower court

tion of this amount 'pending an application for rehearing herein * * *' and the decision of the Commission upon such application for rehearing' (R. 112). A rehearing was held on March 3 and 4, 1941, and an oral argument was had before the Commission sitting *en banc* on May 21, 1941. No order has yet been entered by the Commission as a result of the rehearing and its own stay of its order requiring disposition is still in effect:

"*Inasmuch as the Commission has granted a rehearing and has not passed upon the questions raised therein, the administrative process has not been completed. The question of the disposition of $3,500,000, therefore, is not properly before the Court.*

"The decision of the Supreme Court in *Federal Power Commission* v. *Metropolitan Edison Co.*, 304 U. S. 375, 381-383, is controlling here. * * *

"It follows that the same reason which prevents the running of the time for taking the appeal, prevents this court from acquiring jurisdiction; *i. e., because jurisdiction continues in the Commission to modify, reverse, or affirm its decision.* Upon the filing of its appeal in this court—its petition for rehearing being then undisposed of—appellant occu-

Brief before this Court

470, 479; *Cromwell* v. *County of Sac*, 94 U. S. 351, 352. There thus remains for review merely the subject matter of the Commission's second order, which did no more than prescribe the method by which Northwestern should eliminate the 'write-up' from Account 107, Electric Plant Adjustments. A similar limitation upon the jurisdiction of this Court equally follows from Section 313 (b) of the Act.

"Petitioners, however, in one guise or another, seek to raise now substantially *all the points embodied or subject to decision* in the first judgment of the court below, of which they did not see fit to seek review in this Court • • •. The action of the Commission, they state, viewed in its entirety, violates their rights under the Fifth Amendment, and also infringes upon the powers reserved to the states by the Tenth Amendment. We submit that these objections were correctly *disposed of by the court below on the first review.*" (Emphasis supplied.)

Brief before lower court

pied the anomalous position of asking the Commission for administrative relief, and at the same time asking the court for judicial relief from the anticipated decision of the Commission. • • •

"Finally, even if this court did have jurisdiction over the appeal, a situation would be presented calling for the exercise of judicial discretion to determine whether relief should be denied at this stage of the proceedings, until all possible administrative remedies had been exhausted; and in our opinion the appeal should be dismissed for that reason in any event. We have heretofore suggested that rehearings should be availed of by aggrieved persons both for their own protection, and in order to afford opportunity to the Commission to correct errors or to hear newly discovered evidence before appeal. This is not and should not be an arbitrary requirement. Whether a petition for rehearing should be filed in a particular case must be decided on the merits as each case arises. However, in our view, its use as an administrative remedy should not be discouraged, but instead should be encouraged—'not to supplant, but to supplement' appellate review. • • • *Until the Commission has considered and*

acted upon such a petition, the administrative remedy of the aggrieved person cannot properly be said to have been exhausted, and resort to this court in such cases is, therefore, premature" (Emphasis supplied).

In the case of *American Tel. & Tel. Co.* v. *U. S.*, 299 U. S. 232, this Court held that the Communications Commission's interpretations of its accounting regulations and orders were binding upon it and could be relied upon by the public. And if we adopt this Commission's interpretation of its own order, as the court below did on the first review, then the Commission's administrative function to reverse, modify or otherwise change its order as to the disposition item, upon and after further hearings, was not exhausted until, after the rehearing, it had rendered an opinion and entered an order with respect thereto. The Commission's order of January 21, 1941, which granted a rehearing as to the matter of disposition, did not preclude the possibility that the $3,500,000 might be classified in another account or that it might be allowed to remain in Account 107, even though bearing the "write-up" label. This would not have violated the Commission's original cost accounting system, unless the mere reclassification of any sum in Account 107 is tantamount to an automatic write-off, without regard to asset values, in violation of the petitioners' constitutional rights. *American Tel. & Tel. Co.* v. *U. S.*, *supra*.

> "It may be laid down as a general proposition that, where a party assumes a certain position in a legal proceeding, and succeeds in maintaining that position, he may not thereafter, simply because his

> interests have changed, assume a contrary position, especially if it be to the prejudice of the party who has acquiesced in the position formerly taken by him." *Davis* v. *Wakelee*, 156 U. S. 680, 689.

See also:

> *Michels* v. *Olmsted*, 157 U. S. 198, 201;
> *United States* v. *Chicago, Milwaukee R. Co.*, 282 U. S. 311, 342.

We repeat that the court below, following and adopting the contentions of counsel for the Commission (contentions now repudiated in this Court), denied petitioners an opportunity to be heard and their day in court with respect to significant and appropriately presented questions. *Guaranty Trust Co. of N. Y.* v. *United States*, 304 U. S. 126.

III. "DISPOSITION", AS DISTINGUISHED FROM FULL DISCLOSURE BY CLASSIFICATION, NEITHER "NECESSARY" NOR "APPROPRIATE" TO PERFORMANCE OF COMMISSION'S FUNCTIONS.

"Accounting Principles" Do Not Require Write-off.

We challenge at the outset the proposition (Comm. Br., 11, 48) that "accounting principles" require the immediate writing-off of a write-up supported by actual and existing values and represented, as in this case, by a *bona fide* investment on the part of an affiliated company. It is true that many accountants have questioned the desirability of recording property appreciations in the first place, but assuming that the values actually recorded are supported by objective evidence of increased value, we submit that there is nothing in accounting principles or in accounting litera-

ture to support or compel an immediate write-off. For example, in Accounting Research Bulletin No. 5 of the American Institute of Accountants,[4] it is taken for granted that appreciation of assets will be amortized through the service life of the property. In the current (Third) edition of the Accountants' Handbook, there is an entire section (pp. 785-835) which deals with the subject of plant appraisals, of course including appreciation of plant (defined as "the net enhancement in value as found by the appraiser, excluding the effect of restoration of cost or adjustment of depreciation based on cost", p. 811) and the accounting problems associated therewith. Nowhere in this entire section is there any suggestion that a genuine increase in value which has been recorded in books of account should be summarily eliminated.[5]

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[4] Discussed at pp. 814-815 of "*Accountants' Handbook*" (1943), Third Edition, (Paton, The Ronald Press Company).

[5] "*Accountants' Handbook*", Third Edition, p. 807:

"*Opinions of Accountants.*—While accountants generally accept the cost approach there have been numerous expressions of opinion in favor of at least limited recognition and use of current values. Kester (Advanced Accounting) writes:

In the event of marked change in the purchasing power of the dollar, business prudence may require a revaluation to give a proper basis for the flotation of new securities whose essential soundness will rest, at least partly, on the current value of the assets back of them. Financing is always done in terms of current value conditions, and not in terms of those prevailing at the time of acquiring the assets.

"Daines (Accounting Review, vol. 4) writes: 'As long as economic forces cause changes in value, the accountant should be an impartial recorder of such changes.'

"With respect to appreciation Wildman (Accounting Review, vol. 5) expresses the following opinion:

We cannot agree with the conclusion that appreciation should not be recognized in the books of account. To take the position that closed transactions only are entitled to recognition is to narrow the function of accounting unduly and gainsay many of the well-settled practices. In our opinion, every effort should be made to increase the usefulness of accounting by constantly seeking to find additional data to which expression may be given in financial statements; to refine the data and

Disposition Neither "Necessary" Nor "Appropriate".

The Commission's brief (pp. 41-45) lists the functions vested in the Commission which, it says, "leave no room for doubt as to the appropriateness of a system of accounts based on cost." This itemization abundantly demonstrates that not one of the functions enumerated, whether cost determination, or the requirement of reports, or the regulation of rates, or the collecting of information with respect to the cost of generation, transmission and distribution of electric energy, or the obtaining of data in connection with the regulation of mergers and consolidations or the acquisition of securities could conceivably be impaired if, after having required a detailed classification, on a cost basis, of the accounts of a public utility subject to its jurisdiction, the Commission refrained from requiring the confiscatory disposition of such completely ear-marked items as the $3,500,000 here under consideration. Such an item could not be ignored in a rate or condemnation case and, for all purposes involving the consideration of costs, the facts are available in full detail. The only considerations advanced which might even partially justify the elimination of amounts in excess of cost to the accounting company are the alleged objectives of uniformity and comparability. As to both these objectives, it must be said, first, that electric utilities are essentially local or, at most, regional in

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make them more understandable; to make accounting increasingly more serviceable as a basis for administration.

"On the same topic Hatfield (Accounting Review, vol. 5) comments as follows:

The objection to recording appreciation because it is a vague estimate applies just as truly to depreciation. No one knows whether the estimated depreciation for a given year is correct or not, yet the showing of profits for that year depends, *ipso facto*, on the estimate of depreciation. If all estimates are taboo, we cannot have either an allowance for depreciation, or one for bad and doubtful debts."

character and that no "primary control" over the nation's electric utilities comparable to that vested in the Interstate Commerce Commission with respect to the transportation systems of the country has been conferred upon this Commission (Pet. Br., 33-35). Second, comparisons based on original cost, which assumes an unchanging monetary unit, are often highly illusory.[6] Third, it is submitted that uniformity, particularly uniformity which may, as in this case, be applied arbitrarily, is not a desirable end in itself. Procrustes and his celebrated bed achieved uniformity and an ugly uniformity has been attained throughout much of Nazi-occupied Europe. Furthermore, no such order as that here under consideration has been made by the Commission in any other case and nothing is more probable than that (particularly in view of the *amicus curiae* brief filed in this case) no similar order will be made again. It is suggested, in all events, that our judicial safeguards may well require that uniformity yield to established individual rights.

The So-Called Licensee Cases.

After referring to three Circuit Court decisions which sustain accounting requirements imposed by the Commission upon licensee companies, the Commission's brief (p. 33) makes this astonishing statement: "The authority of these cases is not diminished for present purposes because they involved licensees instead of public utilities, for the only accounting authority over either is that conferred by Section 301(a), and no distinction is made either in that section or elsewhere in the Act between the authority of the Commission over accounts of licensees and its authority over those of public utilities."

[6] See, for example, the illustration set forth at pages 731-732 of Paton's *"Advanced Accounting"*; The Macmillan Company (1941).

That observation is clearly in error. The Commission recognizes in its own system of accounts (R. Vol. III, Ex. 6, p. 3) that the cost of projects licensed under the Act must be determined (Section 3(13) of the Act) in accordance with the 1914 classification of the Interstate Commerce Commission. Section 4(b) of the Act authorizes the Commission "to determine the actual legitimate original cost of and the net investment in a licensed project" and requires each licensee to file a detailed statement showing such cost. Section 3(13) defines "net investment". Section 6 requires each licensee to accept, as a matter of contract, all the terms and conditions of the Act "and such further conditions, if any, as the Commission shall prescribe in conformity with the Act" and Sections 10(c) and (d) provide for the establishment and maintenance of depreciation reserves and of reserves for the amortization of earnings in excess of a specified rate of return. No comparable provisions are found in the sections dealing with non-licensee public utilities. Hence what is "necessary or appropriate", from an accounting point of view, as to licensees, may well be neither necessary nor appropriate as to a non-licensee utility (Pet. Br., 28-31).

Furthermore, each of the cases cited involving licensees lays stress upon the very fact that the company concerned was a licensee, and suggests strongly that the accounting provisions of the Act may not be used to destroy the vested rights of non-licensee utilities. Incidentally, this distinction was made so obvious in the lower court that, in its opinion on the second review, the court did not even cite any of the licensee cases, although they had been strongly relied upon by the Commission in its brief.

Provision Must be Made For "Appreciation".

It is suggested (Comm. Br., 51-52) that the $3,500,000 here in question cannot be carried in any prescribed account; that the retention of such an amount would require the creation of a new account "which would in effect be only[7] a plant appreciation account"; that such an account has no place in a cost system of accounting and that the system prescribed by the Commission specifically forbids the recording therein of appreciation of electric plant. On the contrary, enhanced structural value for which payment has been made by the accounting company is recorded in Account 100.5 (Testimony of Charles W. Smith, the Commission's principal witness; R. 393-396), which would make Account 100.5, in such circumstances, a "plant appreciation account."

"Corporate Veil" Diaphanous in Both Directions.

This Commission, in particular, has refused to permit any "interposition of the corporate veil" (*cf. Pennsylvania Power & Light Company* v. *Federal Power Commission*, ... F. (2d) ....., C. C. A. 3, decided December 7, 1943, cited at page 33 of the Commission's brief) in transactions between affiliates, the Circuit Court having said, in the cited *Pennsylvania Power & Light Company* case, "For an intercorporate profit which upon a consolidated income statement of the affiliated group would disappear entirely is too lacking in substance to be treated as an actual cost." It is respectfully submitted that the corporate veil is no more diaphanous in one direction than in another and that, in this case, the consolidated balance sheet of the affiliated

[7] In the light of the complete propriety of recording appreciation in corporate books of account, this invidious "only" is difficult to justify; *Accountants' Handbook* (Third Edition), pp. 603, 811-820.

group discloses an actual arm's-length investment in the common stock of Northwestern of $5,021,799.33. Furthermore, this investment, when measured by any of the orthodox criteria (Pet. Br. 61-63), is substantiated by very real and existing values which fully support the $3,500,000 here under consideration. And, of course, the entire $5,021,799.33 would be in Account 100.5 (and there would be no talk about a "write-up") if American, instead of purchasing Northwestern's common stock in 1925, had caused its assets to be transferred to a new company (R. 393-402).

System of Accounts May Not Destroy Property Rights.

This Court, in *American Telephone & Telegraph Co.* v. *U. S. supra*, held that the system of accounts there under consideration must be upheld although it may be "unwise or burdensome or inferior to another." If, as the lower court suggested on the first review (R. 816), the system of accounts here under consideration "takes nothing" from the accounting company, but merely requires full disclosure of information, no arbitrary or whimsical action can be attributed to the Commission. But if such system of accounts is employed as the sole standard of determining, adjusting or destroying property and property rights, the Commission's action clearly becomes arbitrary. As for "unlimited accounting authority" (Comm. Br., 32), whatever that may mean, it is suggested that an "unlimited" license to practice chiropody does not authorize the chiropodist to proceed from bunions to brain surgery.

Perhaps the $3,500,000 here in question might be recorded in Account 303, Miscellaneous Intangible Plant (R. 162), but if the system of accounts does not provide for the recordation of such an amount, representing actual investment by American, an affiliated company, and fully supported by values inherent in the property of the accounting

company, then so much the worse for the system of accounts. If a utility had the right (as was the case here), under the laws of the State of its incorporation and operation, to record values supporting its capital structure on its books of account, then a system of accounts which vitiates such recording is fatally defective, since it patently results in the arbitrary taking of property without due process and cannot be regarded as "necessary" or "appropriate" within the meaning of Section 301(a).

Northwestern's 1936 Reorganization Ignored.

Among other things, the Commission, in its findings and opinion, and counsel, in their brief, have attached no significance to the reorganization of Northwestern effected in 1936 pursuant to an independent appraisal of Northwestern's assets (R. 1070-1071). As George O. May, an outstanding leader of the accounting profession, says in his recently published "Financial Accounting",[8] "Therefore, where despite these difficulties [encountered in determining value] it is clear that the existing value is markedly at variance with a book *value* determined on the basis of cost, it should be regarded as permissible and in some cases desirable to recognize current values in the books of account and in financial statements prepared therefrom. However, such readjustments should not be lightly undertaken and should in all cases be subject to the approval of stockholders, given with a formality comparable to that required for the purpose of actual reorganization."

The 1936 reorganization of Northwestern was effected precisely in accordance with the standards Mr. May prescribes. As is indicated in a footnote at page 9 of the Commission's brief, the balance sheet liability of $10,000,000 on account of the Northwestern's common stock was regarded as an obstacle to the payment of dividends on that

[8] May, *"Financial Accounting, A Distillation of Experience"* (December, 1943) p. 102; The Macmillan Company.

Company's preferred stock and it therefore was both necessary and desirable to recognize, on a realistic basis, "current values in the books of account." Accordingly, and after said independent appraisal had been made, Northwestern did what the then Washington statute (Pet. Br. 96-97) seemed to require, effecting a reorganization under which Northwestern's presently outstanding common stock having a par value of $35 per share was issued in exchange for its original $100 par value common stock, thus creating a capital surplus against which the aggregate of Northwestern's assets was written down by $6,500,000. All of the steps taken were formally authorized by the Company's board of directors and its stockholders (R. 870-883).

There can be no question but that this reorganization of Northwestern "by readjustment of securities"[9] was both lawful and appropriate. After it had been accomplished, Northwestern's management felt that its "balance sheet was in fine, respectable shape, that it represented honestly values that were there in the property, and that such problems as had arisen previously with respect to it had been eliminated" (R. 1071). This reorganization faced the facts realistically, giving recognition, among other things, to American's investment in Northwestern's common stock and to the enhancement of not less than $3,250,000 in the structural value of the property of Northwestern at the time American purchased Northwestern's stock (R. 922). This was a legitimate and completely defensible recognition of values then inherent in the property of Northwestern and it affords an appropriate basis for that Company's future accounting.

[9] Fletcher, *Cyclopedia of Corporations*, Perm. Ed., §7215, Vol. 15, pp. 353-354.

Original Cost Accounting and the Value Concept.

Of course value is a difficult concept from the point of view of the advocate of original cost. Indeed, as George O. May says,[10] "The question how far cost and value respectively shall be reflected in books of account and financial statements, may be regarded as perhaps the central question of accounting." Original cost accounting, however, avoids the problem of value by ignoring it.[11] The Pilgrim's Progress of the original cost accountant is: Original cost is one element of value, original cost is the sole evidence of value, original cost is an end in itself, self-justifying and self-justified.

It is suggested to the original cost advocate, who seeks to apotheosize the accountant, or rather the bookkeeper, at the expense of the engineer, the informed executive, the judicial appraiser, whether regulatory agency or court, that ours is still a value economy, not a cost economy; a dynamic economy, not a static economy. To the extent that the original cost accountant says that fixed property does not appreciate in value, he is rather more than mistaken. To be quite specific, any intimation that the presently outstanding common stock of Northwestern is without value is, in the light of this record, patently and completely in error (Pet. Br. 61-63).

This Commission's Own Regulations are Not Sacrosanct.

The Commission's brief fairly bristles with references to what the system of accounts, particularly Account 107,

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[10] May, *"Financial Accounting, A Distillation of Experience"* (December, 1943) p. 86; The Macmillan Company.

[11] Even the Commission's brief (p. 28) quotes a Federal Trade Commission reference to "proper accounting with respect to the *value* of assets."

provides.. It is respectfully urged that there is nothing sacrosanct, whether textually or otherwise, about the system of accounts. The Commission obviously cannot confer authority upon itself by the drafting of accounting regulations apparently intended to have that effect. Thus it is said (Comm. Br., 20-21, for example) "The text of Account 107 itself makes plain that accounts recorded therein cannot remain there permanently but must be disposed of as the Commission may approve or direct." If the effect of that provision is to take property without due process, as it does here, then its having been imbedded in the system of accounts makes no addition to the ambit of the Commission's authority. Furthermore, there is nothing whatever in Section 301(a) of the Act to indicate Congressional intent to confer upon the Commission authority to establish a "uniform system of accounts based on cost" which shall be retrospective (in this case by 25 years) in its application.

Commission's Order Clearly Is, in Intent and Effect, a Dividend Order and Not An Accounting Order.

The contention is advanced (Comm. Br., 17, 60) that the order of the Commission is "not a dividend order." In making the order, the Commission repudiated its accounting witnesses. In defending the order, counsel now repudiate the Commission. For the Commission made the intended purpose of its order unmistakably clear.

In its first opinion, the Commission said (R. 69):

> "• • • Certainly *dividends should not be paid on the Common Stock* until it has the equivalent of a paid-in value." [Emphasis supplied.]

In its second opinion, after having referred to the possibility of charging the $3,500,000 against surplus, the Commission said (R. 1168-1169):

> "* * * In our Opinion and order entered December 6, 1940, we did not dispose of the amount in that manner for the reason that to have done so would have created a large deficit in the surplus account, with the consequent detriment to the preferred stockholders. We were cognizant of the fact that the preferred stockholders had paid some $4,800,000 into the Company (in contrast to the common stockholders who paid nothing into the Company for the common stock) and that some means, if possible, should be found to protect their interests. * * * "

The Commission's avowed purpose thus was to decide to whom dividends should be paid and to whom dividends should not be paid. Its order simply is not, in any proper sense, an accounting order.

As the American Institute of Accountants says in its brief as *amicus curiae* (p. 5):

> "This order was appropriate to effectuate the view expressed by the Commission that 'dividends should not be paid on the common stock until it has the equivalent of a paid-in value', although in view of the existence of the surplus the order may have gone further than was necessary to effectuate its purpose."

It is respectfully suggested that the Commission's whole discussion of the dividend question is like a certain package sent into Norway from Germany. It was labeled "baby carriage" but however often its parts were assembled and reassembled, they always turned into a machine gun. Similarly, whatever effort may be made to conceal or disguise the Commission's order as an accounting order, it is, in effect, purpose and intent, a dividend order.

The order of the Securities and Exchange Commission quoted in Appendix D to the Commission's brief (p. 131)

provides, among other things, that "in no event shall the applicant declare or pay any dividends on its common stock except out of earnings accruing subsequent to said September 30, 1939." If the Federal Power Commission's order in this case were rewritten in similarly direct and honest verbiage, it would provide:

> "In no event shall Northwestern Electric Company declare or pay any dividends on its common stock until the amount of $3,500,000 shall have been entirely extinguished by crediting Account 107, Electric Plant Adjustments, and charging Account 414, Miscellaneous Debits to Surplus, for each year commencing with the calendar year 1940, with a sum equal to its net income (Account 400, Credit Balance Transferred from Income Account) less its preferred stock dividend appropriations for each such calendar year."

Is Northwestern's Capital Impaired?

The Commission's brief states (p. 50) that Section 305(a) of the Act "places a definite limitation upon the right to declare dividends where the capital is impaired" and that "supervision of enforcement of that provision is entrusted to the Commission." If that be true, there is utterly no justification for the Commission's order in this case. Thus if Northwestern's capital is impaired, the Commission should have interdicted the payment of all dividends, *preferred as well as common*. On the other hand, if Northwestern's capital is not impaired, there is no excuse whatever for interfering with the payment of dividends on either its common stock or its preferred stock.

This dilemma must be faced frankly. If, contrary to the law of the State of Washington (*cf. Randall* v. *Bailey*, 288 N. Y. 280; *Edwards* v. *Douglas*, 269 U. S. 204, 214), the *value* of the aggregate of the assets of Northwestern may

not be taken into consideration for the purpose of determining whether its capital is impaired, but, on the other hand, the aggregate of such assets is required to be determined on the basis of the original cost of Northwestern's tangible property, then its capital clearly is impaired and it may no longer pay dividends either on its preferred stock or its common stock until such impairment is made good. In other words, the question is whether the Federal Power Commission system of accounts, which insists that electric utility property declines in value, but denies that it can appreciate in value, or the law of the State of Washington, shall control the fundamental corporate books of account of Northwestern. On this question, the second opinion of the court below is in conflict with its first opinion (Pet. Br., 22) and petitioners submit that they are entitled to have an answer.

Congress certainly must have intended that such authority as the Commission may exercise under Section 314 of the Act with respect to Section 305(a) should be exercised pursuant to State laws applicable to the impairment of capital and the payment of dividends. Furthermore, in so far as cost or cost accounting can be of assistance in this connection, detailed information is available in the classification which has already been made. The Commission's contention in this regard is without significance unless Congress intended capital to be synonymous with cost, but if that had been the Congressional intent, it clearly would not have enacted Section 204(f), preserving to the States the right to control securities of utilities incorporated and operating therein. The contention made by the Commission in this connection affords abundant demonstration of its intention to use original cost to determine whether capital has been impaired and thus whether dividends can be paid, to fix rates, and for every other regulatory purpose.

Federal Power Commission and Securities and Exchange Commission Cover Same Field.

It is urged (Comm. Br., 61) that the Commission's order does not conflict with the rules of the Securities and Exchange Commission promulgated under Section 12(c) of the Public Utility Holding Company Act of 1935. Again adopting the parallel-column technique, we set forth below the salient provisions of Section 305(a) of the Act and the provisions of Rule U-46(a) implementing Section 12(c) of the Holding Company Act:

Section 305(a) of the Act.	Rule U-46 of the S. E. C. General Rules and Regulations under the Public Utility Holding Company Act of 1935 (Comm. Br., 113).
SEC. 305. (a) It shall be unlawful for any officer or director of any public utility to * * * participate in the making or paying of any dividends of such public utility from any funds properly included in capital account.	(*a*) *Dividends.*—No registered holding company or subsidiary thereof shall declare or pay any dividends on any security of such company out of capital or unearned surplus, except pursuant to a declaration notifying the Commission of the proposed transaction, which has become effective in accordance with the procedure specified in rule U-23, and pursuant to the order of the Commission with respect to such declaration under the applicable provisions of the Act.

It is difficult to see any substantial difference between these provisions or to perceive why they do not cover the same field. Surely it will not be contended, in the teeth of Section 318 of the Act, that the jurisdiction of the two commissions is concurrent in this respect. Perhaps it is believed that the two commissions may vie with one another

in this particular field, each seeking to outdo its rival in the severity and the punitive character of its regulation.

"Co-ordination" Between Commissions Clearly an Afterthought.

The suggestions (Comm. Br., 61-62 and [S. E. C. letter] 97, 100-102) that the order here involved has in fact "been coordinated with the requirements of the S. E. C.", and that "the F. P. C. has sought to avoid all question with respect to interference with the S. E. C. order by leaving intact the surplus mentioned in the S. E. C. order and confining the effect of its own order to subsequently created surplus", clearly belong in the category of afterthoughts. There is not a single syllable in the Securities and Exchange Commission's order in the Northwestern case (Comm. Br., 114-128) to indicate that the $983,160.45 of Northwestern's earned surplus "impounded" by the Securities and Exchange Commission as of September 30, 1939, was impounded or restricted except as to the payment of dividends on the Company's common stock. On the contrary, the Securities and Exchange Commission's order expressly recites (Comm. Br., 126) that Northwestern then proposed to write off directly to earned surplus unamortized debt discount and expense, call premium and duplicate interest aggregating $317,711.22 and there certainly is every presumption that the surplus "impounded" as to common stock dividends was available for any other write-off which might seem to be appropriate.

IV. THE COMMISSION'S BRIEF FAILS TO ANSWER PETITIONERS' ARGUMENTS THAT THE COMMISSION'S ORDER VIOLATES ARTICLES V AND X OF THE AMENDMENTS TO THE CONSTITUTION.

Congress Has Not Made Federal Regulation Complete.

The contention is made (Comm. Br., 70) that "Federal regulation of the interstate transmission of electricity may of course properly be made complete." Accepting that statement for purposes of argument, it by no means follows that Congress has already made such regulation complete (Pet. Br. 31-35). And it is an even greater achievement in the sphere of rationalization to imply that, because Congress has conferred upon the Federal Power Commission certain limited powers with respect to the transmission of electric energy in interstate commerce, it has also authorized that Commission, in the guise of mere accounting regulation, to arrogate judicial powers, disregard existing values and strike down vested rights. (Pet. Br. 38-40.)

Of course the Federal government may regulate interstate commerce, but only within and subject to other constitutional guarantees. Rights acquired under State laws before Congress invaded a particular field certainly may not be destroyed without compensation. And here Congress did not authorize the invasion of the field, but expressly refrained from entering upon the regulation of the securities of public utilities operating in and regulated by the States of their incorporation (Section 204(f) of the Act).

Order Takes Property Without Due Process.

Finally, the Commission's order does have the effect of depriving Northwestern and its security holders, including American, of its and their property without due process

of law. It is respectfully suggested that the property of Northwestern itself has been taken, if for no other reason, because the Commission's order of disposition has the effect of determining, finally and definitively, that the property of Northwestern has not appreciated, and cannot appreciate, in value (Pet. Br., 42-43). Depreciation is taken for granted but even the possibility of correlative appreciation is arbitrarily denied. As for American, even the opinion of the court below recognizes that the market value of Northwestern's common stock, in the hands of American, "would decrease, probably substantially, if no dividends can be paid thereon for ten years or more." (R. 1240). It will be recognized that, by reason of the provisions of Section 11 of the Public Utility Holding Company Act of 1935, there is a very real possibility that American will be required to sell the Northwestern common stock which it owns. If such a sale were made while the Commission's order restricting the payment of dividends was in effect, it surely could not be urged that American, in such circumstances, would not have been deprived of its property without due process. Nor does the *Kansas City Southern Railway* case, 231 U. S. 423, afford any justification for such regulatory confiscation (Pet. Br., 71-72).

In essence, the taking here is an attempt to require a stockholder who has acquired fully-paid and non-assessable stock under existing law to pay for such stock again by denying him the ordinary rights flowing from his ownership. If a denial of such rights may be accomplished by the circumvention practiced here, it is suggested that a court may be deprived of its sole jurisdiction to prescribe the death penalty if some regulatory agency may eliminate both food and water from the diet of any person whom it wishes to proscribe.

In *American Telephone & Telegraph Co.* v. *United States supra,* this Court, speaking through Mr. Justice

Cardozo, who certainly was one of the Court's great verbal precisionists, said,

> "* * * The Commission is not under a duty to write off the whole or any part of the balance in 100.4 [the plant adjustment account], if the difference between original and present cost is a true *increment* of value. On the contrary, only such amount will be written off as appears, upon an application for appropriate directions, to be a fictitious or paper *increment*.[12] * * * [Emphasis supplied]
>
> "* * * The forms of the accounts *are* fixed, and fixed by regulations of adequate generality. What disposition of their content may afterwards be suitable upon discovery that particular items have been carried at an excessive figure must depend upon evidentiary circumstances, difficult to define or catalogue in advance of the event.* * *"

American has made an investment of $5,021,799.33 in the common stock of Northwestern here under consideration and there is nothing of a "fictitious or paper" character about the "increment of value" inherent in that common stock (Pet. Br., 61-63). Furthermore the "evidentiary circumstances", which the Commission has regarded as irrelevant, are such as to make the disposition here contemplated clearly arbitrary rather than "suitable".

We urge again the significance in this connection of the statement made by Mr. Justice Brandeis in the *Chicago Junction* case, 264 U. S. 258, 265:

> "* * * The provision for a hearing implies both the privilege of introducing evidence and the duty of deciding in accordance with it. To refuse to consider evidence introduced, or to make an essential finding without supporting evidence, is arbitrary action."

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[12] **Increment.** 1. An increasing; growth in bulk, quantity, number value, etc.; augmentation; enlargement; increase. (*Webster's New International Dictionary*)

Since the Commission has presented to the Court, both in appendix form and otherwise, much material not in the transcript of record, we feel justified in presenting, as Appendix A hereto, excerpts from two chapters in the most recently (December 15, 1943) published definitive text on the subject of accounting, "Financial Accounting, A Distillation of Experience" (The Macmillan Company), by George O. May, formerly senior partner in Price, Waterhouse & Co. and a lecturer at the Graduate School of Business Administration, Harvard University. Petitioners believe that Mr. May's fifty years' experience in accounting enable him to speak with as much, if not more, authority than any other figure in his profession.

Respectfully submitted,

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APPENDIX A.

Excerpts from

FINANCIAL ACCOUNTING

A Distillation of Experience

By

George O. May

(The Macmillan Company, New York)

CHAPTER V.

Cost and Value.

The question how far cost and value respectively shall be reflected in books of account and financial statements, may be regarded as perhaps the central question of accounting. It presents so many phases and gives rise to so many questions, terminological, theoretical, and practical, that much confusion has arisen in discussion of it. Considerations which may be determinative with respect to the treatment of fixed property are not necessarily applicable to the treatment of inventories. The case where value exceeds cost may call for different treatment from that in which it is less than cost. Acceptance of the postulate of continuity naturally leads to emphasis on cost, while recognition of the limited truth of the postulate that the monetary unit is stable may lead to wider recognition being given to value. In this chapter, the question will be considered in its broad aspects and in relation to fixed property; the case of inventories will be considered later.

The first major difficulty is that the word "value" has a great variety of meanings; indeed, Professor Bonbright in his well-known work on the subject says that it is impossible to reconcile even the uses of the word in American judicial decisions except by defining it so broadly as to include any monetary statement about property.[1] The English Companies Act provides that every balance sheet shall disclose how the fixed assets are valued, and the leading commentators agree that they may be said to be "valued" at cost even though they are admittedly worth only a far smaller sum. It has been said that in another English statute the word "value" is used in twenty-seven different senses.

In this discussion the word "value" will connote an attempt to determine worth except where it is italicized, in which cases it will be used in the broadest sense of a monetary statement about property.

When property is new, cost and value are normally the same, and for a considerable time thereafter cost may be the best guide to value. Even when this condition has ceased to exist, cost may be used as a conventional measure of *valuation*. It is important to distinguish between the cases in which property is stated at cost as such, and those in which cost is merely a conventional measure of *value*.

When an election between cost and value has to be made, the choice may differ according as cost or value is the greater. There are many cases in which value will be preferred to cost if it is the lower of the two, but not if it is the higher. The alternative basis of cost or market value, whichever is the lower, for *valuing* inventories, is an outstanding illustration. This rule may be accepted on a pragmatic basis because of its demonstrated merits; alternatively, it may be defended on the ground that only useful costs should be carried forward, and that the fact of value being less than cost is evidence of a loss or cessation of utility. When value is in excess of cost, any attempt to

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[1] *The Valuation of Property. J. C. Bonbright* (1937), Vol. I, page 38.

recognize it in accounting must have regard to the definition of income as realized gain, to which there are no recognized exceptions in the accounting for manufacturing and trading operations (though there are in the accounting for transfer income, such as interest). There is not the same insistence on realization as a condition precedent to accounting recognition in the case of losses as in the case of gains.

The question whether cost or value should govern in specific cases is clearly one that might be answered differently according to the purpose for which accounting statements are designed. In particular, a conflict may be recognized between the requirements necessary to meet the older uses of accounting statements and those that will serve the newer use as a guide to earning capacity.

Changes in the value of property may be due to a variety of causes. An appreciation of property in terms of a stable monetary unit has a different significance from one that reflects only a decline in the value of the unit. Perhaps the most difficult of all problems in this field is presented where a decline in value as the result of use or obsolescence is either accelerated or offset by a change in money value due to fluctuations in the price level. The disentanglement of the elements in such cases is essential to sound accounting treatment.

With this formidable catalogue of difficulties in mind, the specific case may be considered of fixed assets having a value that is greater than cost. Fixed assets by definition consist of property which is intended to be used and perhaps ultimately consumed in connection with the business, and is not ordinarily offered for sale.

The question at once arises—how can value be measured in such a case? Clearly there is no exchange value for such property in the sense in which the economists use that term, since no market for the property exists. If the fact that value is higher than cost is due to a decline in the value of the monetary unit, the solution may be to adhere to the cost basis but to accept the view that cost must be expressed in a unit that is uniform, and adjust the dollar cost accordingly.

Apart from this case, the efforts to find a measure of value for fixed property not intended for sale have proved unsatisfactory, and the justification of the cost basis rests, perhaps, more on the inherent defects of any suggested method of valuation than upon the abstract merits of the cost approach itself. However, there are cases in which value is clearly in excess of cost when both are measured in terms of the same monetary unit, and the question whether recognition should be given to the higher value in such cases should not be decided solely on the grounds of the practical difficulties of measuring value. This is particularly true in an economy like ours, in which capital gains are regarded as income and capital values are important for a variety of purposes, such as taxation and determination of the validity of dividends. . . .

In America, the emphasis on valuation was in earlier days far greater than in England, and it is only in very recent years that the propriety of recording appreciation on books of account has been questioned. Many citations from American writers could be given in support of the foregoing statement. It will suffice to offer a single quotation from an author of unquestioned standing, whose English background made him thoroughly familiar with the case for carrying assets at not more than cost. A. Lowes Dickinson in 1913 said:

> It is necessary to recognize that there are causes at work, particularly in young and growing communities, which may render a statement prepared on the basis of cost of capital assets misleading and even prejudicial to the proper interests of present owners.[1]

This quotation is interesting not only because of its author's eminence and English origin but because of its date, which just preceded the first world war. From the depression that began in 1893 there had been a steady rise in

[1] Dickinson, *Accounting Practice and Procedure* (1913), page 80.

prices, which from 1896 to 1913 averaged about 2 per cent per annum cumulatively for wholesale prices. As Professor F. C. Mills has said, this rise "provided one of the most fundamental of the conditions under which business men of that era worked."[1]

The war brought a further rise, so that in 1922 the wholesale price index was roughly 50 per cent greater than in 1913. It is not surprising, therefore, that the view expressed by Dickinson in 1913 is to be found in Paton and Stevenson, 1918, and Montgomery (4th edition), 1927.[2]

In discussion of tax problems such as those of invested capital, replacement reserves, and capital gains, the late Dr. T. S. Adams during the first world war stressed the point that cost figures gradually lost their significance, and he expressed the view that capital assets should be revalued at intervals—say once in a generation.

When the Special Committee on Cooperation with Stock Exchanges of the American Institute of Accountants addressed its letter of September 22, 1932, to the New York Stock Exchange it undertook to list certain generally accepted accounting principles. It is significant that no prohibition against recording unrealized appreciation was included in this list.

During the last decade there has been a change of viewpoint which may be regarded as the result of an unusual combination of financial, political, and social forces. Today, it is a fairly generally accepted rule of accounting that unrealized appreciation should not be recorded on books of account. Write-ups of fixed assets are in many quarters strongly disapproved. Not only is this so, but past write-ups are condemned, as if they had been originally violations

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[1] *Recent Economic Changes in the United States* (1929), Vol. II, page 609.

[2] Some arguments against reappraisal were discussed in an article entitled "The Problem of Depreciation," which appeared in the *Journal of Accountancy*, Jan. 1915, and is reproduced in *Twenty-five Years*, Vol. I, page 149.

of a fundamental principle instead of being merely something that is outmoded today.

Even those who regard capital gains as income concede that an apparent gain due to a fall in the value of the monetary unit is not true income. Economists have pointed out that currencies are really suitable as a medium only for transactions which do not require any great length of time for their completion. They have endeavored to formulate plans for a standard of value that would be better suited to the adjustment of long-term transactions. In doing so, Marshall (in 1887) pointed out that the need was a modern one; that in earlier ages contracts to make definite payments at distant times were rare, though now they had become common.

The assumption of stability in the monetary unit was clearly not valid in respect of the measurement of income derived from the conversion after 1920 of assets acquired in the years of the century prior to the first world war.

Following the war and immediate postwar rise and a precipitate fall, the price level became stabilized in 1922; and in the years that followed, as Bauer and Gold[1] point out in their discussion of utility valuation, the new price level came to be regarded as virtually permanent. At the same time, the effort to impart liquidity to securities representing enterprises of a permanent character, to which reference has more than once been made, became intensified, with a corresponding increase in emphasis on the income account as a measure of earning capacity and thus a guide to value.

In measuring earning capacity it is advantageous to express revenues and charges against revenue in terms of a monetary unit of the same value. The recent movement in favor of the last in, first out method of valuation of inventories reflects this desire. Many of the write-ups of fixed properties between 1920 and 1930 were efforts to reflect the change in the value of the monetary unit in the subse-

[1] *Public Utility Valuation for Purposes of Rate Control* (1934), p. 105.

quent depreciation charges against income. So long as these write-ups were based on reliable evidence and the resulting credits were excluded from income and from earned surplus (so that the rule against including unrealized gains in income was not infringed) there was ample theoretical and practical support for them. If the verdict upon them is made to depend on whether they were reasonable in the light of the circumstances when the entries were made, such write-ups must be held to have been fully justified. It is only in the light of later developments and on the basis of new modes of thought that they can be indiscriminately condemned.

Unfortunately, in some cases write-ups were not based on satisfactory evidence and had no justification whatever, and criticism, warranted in these cases, has too often taken the unjustified form of condemnation of the procedure itself.

However, even during the 1920's the emphasis on income and earning capacity had produced other effects than a disposition to express depreciation charges in terms of current purchasing power. The strange anomaly came to be recognized that lower book *values* meant lower depreciation charges, which in turn would result in larger reported earnings per share and so in higher *values* per share as measured by the process of capitalizing earnings. At the same time, the shift of emphasis made the lowering of the book *value* per share of minor significance. Recognition of these facts afforded a strong check to the movement to record appreciated values on books of account.

Reference to prospectuses of the period will show that in many cases the book *values* were left unchanged and the higher appraised values were recorded only as notes on the balance sheet or in the text of the prospectus itself. By adopting this procedure it was possible to bring the higher values to the notice of the investor without the necessity of increasing depreciation charges. It was even possible to get a third benefit in the form of credit for conservatism and for conformity to academic thought, which then, as now, favored recording values other than cost only in footnotes or supplementary statements.

The depression that began in 1929 created new conditions favoring a close adherence to cost as the basis of fixed asset accounting. Overcapacity and a resulting lack of earning power tended to offset the earlier rise in the price index as a factor affecting the dollar value of fixed assets. We had passed out of the pioneer stage into the first stages of a controlled economy. Regulation and other political forces, as well as taxation, were limiting the opportunity to secure profits based on increments in real value, to say nothing of mere increments in dollar reproduction costs. The tendency to write up properties was not only checked but reversed, and write-downs became frequent. At the same time, particularly in the public utility field, past write-ups—some of which were warranted and others unjustifiable—were being scathingly criticized in the course of a movement to strengthen governmental controls. In a conference with members of the Federal Trade Commission, following the passage of the Securities Act of 1933, the use to be made of the power granted the Commission to prescribe accounting methods was under discussion. A commissioner dilated on the necessity for stringent rules against the vice of write-ups. I suggested that the necessity had already passed, and that, in private industries at least, the danger was, rather, that assets would be unduly written down for the purpose of reducing depreciation charges against income. I had made a similar comment in an article published in 1932.[1]

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While, in the past, to record appreciated values on books of account has been regarded as permissible, this has never been considered as compulsory, however large and well assured the appreciation may have been. The question arises whether managements should be permitted to recognize or refuse to recognize such appreciation at their option, and if so, what terms should be attached to the exercise of such an option. Clearly the formation of a new corporation would create a right and, indeed, an obligation to record

[1] "The Influence of the Depression on the Practice of Accountancy," *Journal of Accountancy*, Vol. LIV, p. 336.

the values of the assets acquired at the date of acquisition, and it may well be that the recognition of new value on books of account of a continuing company should be regarded as a quasi-reorganization.

In the case of downward adjustments, this concept of quasi-reorganization has been developed, and it would seem desirable that it should be applied, also, to recognition of increases in value. This would mean that the readjustments in either direction would require to be disclosed to and approved by stockholders with substantially the same formality as would be required to effect an actual reorganization. Subject to this requirement it would seem to be wise to recognize the propriety of upward readjustments to values which are adequately demonstrated and are clearly not of a purely ephemeral character.

A special case is presented where an excess of current value over depreciated book *values* is clearly due to overestimation of depreciation in the past. This question, however, forms a part of the general subject of corrections of past estimates rather than a part of the problem of deciding to what extent cost and value respectively should be recognized in accounting.

The case in which value is less than the balance of cost which has not been amortized is of more practical importance and presents more problems than the case in which value is the higher figure. The fact that earnings are large may result in an increase in the value of an enterprise, but in the case of manufacturing and trading corporations that increase in value does not ordinarily attach to the physical properties employed in carrying on the enterprise. The question how far a decline in earnings calls for adjustment of property values is one of great difficulty. Depreciation schemes today normally aim to provide for obsolescence as well as for physical deterioration, and a decline in earning power may be evidence of obsolescence—not only in particular units of property but in complete plants or even enterprises.

No important accounting problem has, perhaps, received less adequate discussion than the question whether a decline in earnings for any considerable period should be regarded as calling for a downward adjustment of the book *values* of the property, and if so, how that charge should be treated in the accounts.

In England, it is clear that such an adjustment is not called for. In general, American practice would seem to be in accord with that of England, though no doubt passages could be found in accounting literature to support the view that such adjustments ought to be made.

Manifestly it is not easy to determine whether declines in earning capacity are temporary or relatively permanent, nor is it easy to decide to what extent they are inherent and how far they may be due to poor management. Moreover, the accounting considerations bearing on the question may differ according as the decline in earning capacity appears to be due to competitive inferiority or to a decline in the earning capacity of an entire industry. As has been suggested, an attempt to reflect changes in the capital value of prospective income in measuring current income or surplus raises difficult technical problems and important questions as to the significance of the resulting figures.

Where the decline in value is not due to a fall in earning capacity caused by competitive inferiority it would seem undesirable to lay down any rule which would require a write-down. Managements should, perhaps, be encouraged to give recognition to such declines through reorganization or quasi-reorganization. There is something incongruous in basing accounting on property *values*, which, if real, would imply a value for the stock of the corporation of $100 per share when the stock persistently sells at from $10 to $15 per share. But as an English judge, in discussing a somewhat similar question, said: "It may be a precept of prudence and yet be far removed from the sphere of the categorical imperative."[2] Just how such an adjust-

[2] *Ammonia Soda Co.* v. *Chamberlain* (1918), 1 Ch. 275.

ment should be made will form part of the question of the treatment of capital gains and losses in general, which is reserved for discussion in a later chapter.

The obligation, or right, of a management to write down property cannot be determined without consideration of the equitable rights of the owners of different classes of securities that may be outstanding. If a corporation has issued preferred stocks or bonds on the basis of a balance sheet, this may be regarded as implying an obligation to provide out of revenues for any decline in the useful value of such assets before making any distribution on junior securities. In such circumstances a corporation should not be permitted to reduce the book *value* of the assets to current value and thereafter compute depreciation on the basis of the reduced value, if that action would prejudice the position of the senior security which the corporation has a legal or a moral obligation not deliberately to impair. Subject to appropriate recognition of these equities, accountants should encourage corporations to deal through quasi-reorganizations with inheritances from the past which have lost their old significance. Such readjustments are likely to promote efficiency as well as to remove possible causes of misconception on the part of stockholders. However, they should, if undertaken, be comprehensive, and not limited to readjustments which will improve future earnings made without regard to offsetting favorable inheritances.

The conclusion to which this discussion leads is that primarily the accounting for fixed assets should be based on cost, but that perhaps the strongest argument in favor of this procedure is the difficulty and uncertainty that are encountered in determining value. Therefore, where despite these difficulties it is clear that the existing value is markedly at variance with a book *value* determined on the basis of cost, it should be regarded as permissible and in some cases desirable to recognize current values in the books of account and in financial statements prepared therefrom. However, such readjustments should not be

lightly undertaken and should in all cases be subject to the approval of stockholders, given with a formality comparable to that required for the purpose of actual reorganization. Care should be exercised to distinguish between readjustments which represent corrections of past estimates of depreciation and those due to causes to which recognition is not ordinarily given in current accounting practice. In all cases, the fullest consideration should be given to the equitable rights of different classes of stockholders in determining whether a readjustment shall be effected and what changes in the method of determining income may properly result therefrom.

When it is said that accounting should be based on cost, the implication is merely that cost should form the starting point for the determination of the sum at which the property shall be carried. There remain certain questions as to the determination of cost and also the question what deduction from the initial cost should be made from time to time in respect of the fact that the life of property units is not perpetual, or, to use the common language of accounting, for depreciation. These subjects will be considered in the chapters that follow.

CHAPTER XIV.

Accounting and Regulation.

* * * Until 1933, the stock exchanges were the arbiters on the question of what constituted reasonable disclosure, exercising this authority through their ability to attach conditions to the listing of securities. The Securities Exchange Act of 1934 transferred this jurisdiction to a commission, which shortly thereafter was given authority to deal with various other factors of corporate life—not in the interest of traders or investors, but from the standpoint of a broad public interest. In recent years, other commissions have been created or have been given additional powers, and have thus acquired jurisdiction over accounting matters. Accounting has come to be recognized

as more largely affected with a public interest. Today, the interests of the long-term investor and the trader alike are subordinated to other interests in a large part of the corporate field. Even the policy of the Securities and Exchange Commission under the Act of 1934 is inevitably affected by its actions taken under other laws. The current and prospective effects of these developments are matters of great importance to accountants and to those who rely on accounts.

Already we see commissions which are vested with policy-making, regulatory and quasi-judicial functions seeking freedom from legal restraints by asserting the higher authority of accounting principles, old or new, laid down by them and based supposedly on considerations of equity or economic reality. They next undertake to relax the application of such principles as a matter of regulatory expediency or administrative policy. Thus, with the aid of legal presumptions of administrative expertness and impartiality, accounting may be made superior to law but still remain the not too rigid implement of policy. Acceptance of some postulates of accounting, such as those of its utilitarian character and the stability of the monetary unit, and disregard of others, such as those of continuity and consistency, have resulted in the development of concepts of accounting new in the field in which they are applied, of which original cost and straightline depreciation in the utility field, discussed in earlier chapters, are perhaps the most notable. If the procedure is challenged in the early stages the defense is that only methods of recording and no substantive rights are involved. But once the record is established it is made the basis of orders which affect rights but are in practice almost irreversible. In the Telephone case, the Supreme Court insisted on a stipulation designed to protect the utility from the practical effects of what was claimed and held to be only an order for classification of accounts. Later events have created doubts as to the effectiveness of such protection.[1]

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[1] *In re* Northwestern Electric Company, *infra*.

The grant to a regulatory commission of power over accounting in unregulated industries was not and could not have been supported by a claim that abuses had developed in that field which did not exist where accounting was regulated. On the contrary, the practices which had become discredited were more general in the regulated industries (and among the utility holding companies) and had spread from those fields to unregulated industry to only a minor extent if at all. This is true of the nonacceptance of the cost amortization concept of depreciation; of questionable reappraisals and improper charges against capital surpluses arising therefrom; of pyramiding of holding companies; of periodical stock dividends improperly accounted for; and of the practice of charging to surplus items which more properly belonged in the income account. These together constitute the major defects of accounting that had developed in the prosperous period that ended in 1929 and in the depression that followed.

Control over accounting has been advocated in the past for the purpose, among others, of securing uniformity. It has been emphasized in earlier chapters that uniformity in the treatment of other than routine transactions is not always attainable because there may be a question whether resemblance or difference between transactions is the more significant from an accounting standpoint. Quite apart from this fact, however, it would be erroneous for the investor to assume that control by commissions and similar bodies is likely to produce a maximum of uniformity. Examination of decisions and classifications will disclose a disturbing number of cases in which disposition is to be "as directed by the commission" or to be determined in some similar way.

Departures from principles on the grounds of expediency have long been an incident of regulatory practice. Three types of cases may be considered. First come those in which authorities have been vested with the duty of enforcing statutes which required securities to be stated

in accounts at their "market value." On more than one occasion such bodies have authorized the use of "values" for securities which no accountant would have felt justified in accepting as conforming to the standard in the absence of such regulations. A second type of case is illustrated by the authorization given to the carriers by the Interstate Commerce Commission to charge repairs and losses from retirement to profit and loss (surplus) and not to operating expenses, to which reference has been made in Chapter VIII. A third class of cases includes those in which commissions have expressly authorized departures from accounting principles on the ground of regulatory expediency.

To raise questions about departures from principles is not necessarily to doubt their practical wisdom. In the first class of cases, rigid adherence to the statutes would no doubt in some cases, at least, have produced consequences that would have been disastrous to those whom the statutes were designed to protect. Moreover value, and even fair market value, are unquestionably vague concepts. The rules made were of universal application and were not discriminatory. In such cases the question that suggests itself is, perhaps, whether the statutes were well conceived or whether they should not have anticipated the situations which gave rise to the special rules, especially as there was nothing novel about those situations.

In the second class the same considerations may have existed, though it is difficult for any accountant to accept the view that ordinary current repairs could be properly charged to surplus accumulated in the past, without a fundamental change in accounting concepts.

The deferment of depreciation accounting by the Interstate Commerce Commission for eleven years after it had been decided upon does not present quite the same question. Here, there was a choice between two methods of accounting, and the balance of argument in favor of the new method was narrow if, indeed, it existed.

Some of the cases arising in the third class present still other questions. Decisions under which costs and losses incurred in the past were carried forward to be charged against the future, might be wholly acceptable if related to the doctrine of quasi-contract between utilities and consumers even though they might otherwise be disapproved by independent accounting opinion. These considerations are inapplicable to other instances, such as decisions which relate to intangible assets, capital structures or fiscal policies and lie outside the area in which the doctrine of quasi-contract has any application.

One such case has elicited vigorous criticism by the Institute and has produced extended discussion; it presented many questions of current importance besides that of the relation between law, accounting principles and regulatory policy, but only that aspect of it will be considered here. The original transaction which gave rise to the question to be decided was, according to the Commission's findings of fact, a flagrant example of a form of corporate abuse which, common and tolerated when it occurred a generation ago, is now discredited. But while this may avert sympathy it makes consideration of the implications of the decision even more desirable.

The order of the Federal Power Commission in question was made in the case of the Northwestern Electric Company in April, 1942. It raised technical accounting questions and also the much broader issue of the proper function of accounting.

The facts as found by the Commission were very simple. The Company had outstanding common capital stock with a par value of $3,500,000. The original issue of stock had been made in or before 1915, and the Commission had found that no consideration had been received therefor. The stock had been acquired by its present holders in 1925 at a cost of over $3,000,000. The Company had a surplus derived from earnings[1] of approximately $1,000,000. Its

[1] This surplus was apparently restricted as to distribution by an order of the Securities and Exchange Commission.

annual earnings in excess of preferred dividends were between $150,000 and $200,000 a year. The Commission had called upon the Company to submit a proposal for disposing of the debit balance of $3,500,000 created in respect of the stock issued. On the Company's failure to submit a plan the Commission, after a hearing, ordered that the Company should apply against the balance a sum equal to its net income "less its preferred stock dividend appropriations for each such calendar year until the amount of $3,500,000 shall have been entirely extinguished."

In directing the disposition the Commission said, first, "* * * we find that it is in the interest of consumers, investors and the public to direct the disposition," and second, "This disposition, assuming adequate earnings, is the equivalent of obtaining ultimately from the holders of the common stock (the holding company) a consideration of $3,500,000 for the stock." A brief filed later on its behalf states that the Commission "was extremely anxious to protect the interests of Northwestern's preferred stockholders."

The Chief Accountant of the Commission had testified that as far as accounting principles were concerned the amount should be removed from the books of the Company at once—adding, however, "A policy and not an accounting principle may call for spreading the amount over a reasonable period of years in the future." He expressed the view that the period "should not be more than ten years, five years being a much more desirable period." He restated his position as being that, "in other words, the amount does not belong on the books of account at all, hence the period of amortization, if amortization is approved, should be as short as possible."

The matter under consideration was thus how a debit balance carried in respect of capital stock issued without consideration should be disposed of. The question could obviously be regarded from the standpoint of legal or equitable rights or from that of wise financial policy; but the Commission was exercising a purely accounting author-

ity, so that only the strictly accounting aspects of the question need to be considered.

Theory might lead to the conclusion that if the law permits stock to be issued without consideration and no right against the holders of the stock is created by such an issue, then the stock issued should be carried at or adjusted to a purely nominal figure for record purposes only, with a corresponding nominal debit balance. Such a disposition would meet the requirements suggested by the Chief Accountant of the Commission.

On the other hand, practice, as illustrated by the classification of the Interstate Commerce Commission for carriers, both before and since its revision as of January 1, 1942, has contemplated that, where a stock is issued at a discount from its par value, the par value should be shown on the credit side and a "discount on capital stock" account set up which is not required to be amortized or disposed of in any way.

A charge of discount on stock to a surplus representing a demonstrated appreciation in value would have been regarded until quite recently as permissible, but would not now be approved. A charge to a surplus created either by a reduction of legal capital or out of earnings would clearly be permissible, and the Commission has authorized such dispositions in other cases. Whether a charge against surplus earnings over a period in the future would conform to accepted accounting practice—assuming that no existing surplus was available—is highly doubtful. That such a disposition is unacceptable when a surplus already exists and is left undisturbed seems clear beyond question.

In so far as the Commission ignored the existing surplus, its action is without support in accounting theory or in the testimony of its own accountants. It is open to the obvious and serious objection that it permits what the Commission has decided to be a nonexistent asset to be carried for a period of years and a surplus to be carried at the same time without apparent reason.

The Commission's action in requiring the write-off to be made to the extent of approximately $1,000,000 out of future surplus instead of existing surplus is irreconcilable with its objective and unnecessary for the purposes which it regarded as determinative of the proper disposition of the amount. Even, therefore, if it were assumed that the Commission had the broadest power to determine what was equitable rather than what was called for by good accounting, it would be impossible to justify the order in this respect.

The case thus raises far more than a technical accounting question regarding the proper disposition of a particular balance. It presents the question whether it is a function of accounting to prescribe what a corporation shall do with its net income after that net income has been determined in accordance with accounting principles. That this is what the Commission undertook to do is clear, since the order calls for a disposition of net income and, indeed, of balances of net income after the payment of certain dividends. It also raises the question whether it is a function of accounting to supplement corporation law, as by making an order which "is the equivalent of obtaining ultimately from the holders of the common stock (the holding company) a consideration of $3,500,000 for the stock." It raises the questions whether accounting principles are subordinate to regulatory expediency and whether a commission can depart from accounting principles as laid down by its own witnesses and still justify its orders on the ground that it is adhering to those principles.

Finally, the issue of discrimination and punitive intent is presented by the facts that the Commission's order goes beyond what is necessary for even the purpose asserted; is contrary to the opinion of its own accountant and all accounting theory, and is at variance with its orders in other cases.

On appeal, the Circuit Court of Appeals for the Ninth Circuit upheld the order, dismissing the point made in

regard to the ignoring of the existing surplus with the curiously irrelevant comment that this contention was "not pertinent because it has no bearing on the 'original cost' theory of the system of accounts." It is apparent that the Court either was unwilling to review the order or completely failed to apprehend the accounting point involved.

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There would seem to be an opportunity for accountants to render a public service and to regain professional ground lost through grants of power over accounting rules to other bodies in and since 1933. The courts are not expert in accounting, and our methods of informing them on technical matters are deficient, as anyone who has had experience as an expert witness must realize. Decisions on important general issues should not be allowed to depend upon the skill and knowledge displayed by counsel and witnesses for the parties or upon fortuitous aspects of the cases in which the issues are first raised. The alternative is for the profession to follow events closely and to intervene through its Institute in an expert and disinterested manner and in whatever way may be appropriate when issues of sufficient general importance appear to be at stake. Such a policy will tend towards consistency in the decisions of various regulatory bodies and also between regulated and unregulated accounting. • • •